

October 31, 1991

**COORDINATED ISSUE
AEROSPACE INDUSTRY
DEDUCTIBILITY OF ILLEGAL BRIBES,
KICKBACKS AND OTHER PAYMENTS**

Issue

Whether illegal payments, bribes and kickbacks made to a government official or employee of the U.S. Government or a Foreign Government can be classified as a trade or business expense under section 162 of the Internal Revenue Code.

Background

Prior to the enactment of section 162(e), illegal payments, bribes and kickbacks have presented a considerable problem to the Service when characterized as a cost of goods sold item.

This was brought about principally by the rationale of the Tax Court in the Pittsburgh Milk Co. case.

In Pittsburgh Milk Co., the taxpayer sold milk to its customers at the price required by the state's milk control law with the understanding that a portion of the sales price would be refunded. The refunds were then claimed as "deductions". The Service contended that since the payments were claimed as deductions rather than cost of goods sold they should be disallowed because the payments frustrated sharply defined public policy. The Tax Court stated that, "terminology alone is not controlling. The determining factors are the intent of the parties and the purpose of the payment. Where the intent and purpose of the payment represents an adjustment of the selling price, then regardless of the time or manner of the adjustment the net selling price agreed upon must be given recognition for income tax purposes."

1. 26 TC 707 (1956), Nonacquiesced 1962-2 CB 5 (withdrawn); Nonacquiesced 1959-1 CB 6 (withdrawn).

In cases where illegal payments were made between sellers and persons other than the buyer, the courts did not follow the Pittsburgh Milk principle. The leading case in this situation was United Draperies Inc. In United Draperies the taxpayer made illegal payments to officers in charge of purchasing for manufacturers of mobile homes. The payments were made to induce purchases by the recipient's employees of draperies produced by the taxpayer. The court held that since the payments were independent of any agreements with the purchaser to fix the selling price, the payments could not be

netted against gross income. The court also ruled that the payments could not be claimed as deductions because necessity could not be established, where to do so would frustrate a sharply defined national or state policy.

Law

Code Section 162(c)(1), prior to amendment by P.L. 97-248, applies to payments made before September 4, 1982.

(c) Illegal Bribes, Kickbacks, and Other Payments, --

(1) Illegal Payments to Government Officials or Employees. -- No deduction shall be allowed under subsection (a) for any payment made, directly or indirectly, to an official or employee of any government, or of any agency or instrumentality of any government, if the payment constitutes an illegal bribe or kickback or, if the payment is to an official or employee of a foreign government, the payment would be unlawful under the laws of the United States if such laws were applicable to such payment and to such official or employee. The burden of proof in respect of the issue, for the purposes of this paragraph, as to whether a payment constitutes an illegal bribe or kickback (or would be unlawful under the laws of the United States) shall be upon the Secretary to the same extent as he bears the burden of proof under section 7454 (concerning the burden of proof when the issue relates to fraud).

Code Section 162(c)(1), as amended by P.L. 97-248, applies to payments made after September 3, 1982.

(c) Illegal Bribes, Kickbacks, and Other Payments. --

(1) Illegal Payments to Government Officials or Employees. -- No deduction shall be allowed under subsection (a) for any payment made, directly or indirectly, to an official or employee of any government, or of any agency or instrumentality of any government, if the payment constitutes an illegal bribe or kickback or, if the payment is to an official or employee of a foreign government, the payment is unlawful under the Foreign Corrupt Practices Act of 1977. The burden of proof in respect of the issue, for the purposes of this paragraph, as to whether a payment constitutes an illegal bribe or kickback (or is unlawful under the Foreign Corrupt Practices Act of 1977) shall be upon the Secretary to the same extent as he bears the burden of proof under section 7454 (concerning the burden of proof when the issue relates to fraud).

(2) Other Illegal Payments. -- No deduction shall be allowed under subsection (a) for any payment (other than a payment described in paragraph (1)) made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or

other illegal payment under any law of the United States, or under any law of the State (but only if such State law is generally enforced), which subjects the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business. For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer. The burden of proof in respect of the issue, for purposes of this paragraph, as to whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment shall be upon the Secretary to the same extent as he bears the burden of proof under section 7454 (concerning the burden of proof when the issue relates to fraud).

Summary and Conclusion

Under section 162(c) illegal payments made to U.S. Government officials and employees are not allowable. Also, if the payment is to an official or employee of a foreign government, and is unlawful under the Foreign Corrupt Practices Act, no deduction shall be allowed.

In the aerospace industry where illegal payments are seldom, if ever, made between the buyer and seller, the United Draperies case also serves as authority to disallow illegal payments as cost of goods sold. In that case the court ruled that illegal payments made to third parties to induce the buyer to make purchases from the seller (payor) were independent of any agreement with the purchaser fixing the selling price of the product sold. Therefore, the payments were not adjustments of the selling price and were not includable as cost of goods sold.

In cases where any 162(c) type expenses are claimed as deductions (as opposed to being claimed as cost of goods sold) regardless of whether the payments are made directly between buyer and seller or through a third party, criminal potential exists and the case should be referred.

In addition, a referral to the appropriate Federal Agency should be made under IRC 6103(b)(3).